

Principles *of* Risk Management *and* Insurance

Eighth Edition



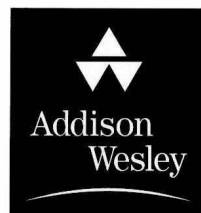
GEORGE E. REJDA

PRINCIPLES OF RISK MANAGEMENT AND INSURANCE

EIGHTH EDITION



GEORGE E. REJDA



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PREFACE

In the two years since the seventh edition of *Principles of Risk Management and Insurance* was published, a number of events have stunned the nation. The bubble of prosperity created by rampant speculation that rocketed stock prices to atmospheric levels burst abruptly, causing investors and speculators to lose billions of dollars. The Enron Corporation, exposed for corporate greed and aggressive accounting that concealed billions of dollars of debt, collapsed and had to declare bankruptcy. Thousands of employees who invested in Enron stock lost most of their retirement savings. In addition, Tropical Storm Allison—just one of the many storms, hurricanes, and tornadoes that wreak havoc on the United States every year—was especially severe, causing \$2.5 billion in insured losses in 2001. Most tragically of all, on September 11, 2001, a shocked and horrified nation witnessed terrorist attacks on the World Trade Center and the Pentagon. At the time of this writing, more than 3,200 people are believed to be dead or missing as a result of the attacks. The reverberations from these astounding losses have rippled across all areas of our society. The insurance industry alone experienced the largest single catastrophic loss in the history of the United States, with estimated losses totaling \$40 billion.

Fast forward to the present. The war on terrorism continues, with military commitments overseas; President Bush's newly created Office of Homeland Security strives to protect the country; Congress has established a victims' compensation fund, passed an airline bailout bill, and limited the airlines' liability for the September 11th attacks; airport security remains tight; and the media and public continue to grapple with why terrorists hate the United States. Arthur Andersen, Enron's former accounting firm, faces criminal charges brought by the Justice Department on the grounds that the firm obstructed justice and shredded documents; the stock market is staging a weak recovery; and hurricanes, tornadoes, floods, and earthquakes continue their awesome destruc-

tion. To say that we live in a risky world and that things have changed since the publication of the seventh edition is an enormous understatement.

Likewise, the insurance industry has experienced rapid changes in the last two years. Property and liability insurers raised premiums sharply in response to the September 11th tragedy; companies and reinsurers inserted provisions in their policies excluding acts of terrorism; and the industry lobbied Congress for a federal backup plan in the event of future attacks. In addition, the property and liability industry experienced a "hard" underwriting cycle in which underwriting losses increased, and profitability declined. Recent underwriting losses were especially severe; the combined loss and expense ratio for 2001 was 118 percent. Other significant changes included the introduction of new commercial property insurance, liability insurance, and crime insurance programs by the Insurance Services Office (ISO); the increased use of credit scoring in underwriting and rating by auto and homeowners insurers; and new tax legislation that significantly increased the annual contributions to qualified retirement plans. Finally, the President's Commission to Strengthen Social Security released its final report and offered controversial recommendations to save the program.

The eighth edition of *Principles of Risk Management and Insurance* discusses these and other changes. As in earlier editions, the text is designed for a beginning undergraduate course in risk management and insurance with no prerequisites. Thoroughly revised and updated, the eighth edition provides complete and current coverage of the major areas in risk management and insurance. Coverage includes basic concepts of risk and insurance, risk management, legal principles, property and liability insurance, life and health insurance, employee benefits, social insurance, and functional and financial operations of insurers. This new edition once again places primary emphasis on insurance consumers

and blends basic risk management and insurance principles with consumer considerations. In addition, it addresses personal risk management and financial planning, so that students can apply basic concepts immediately to their own lives.

CONTENT CHANGES IN THE EIGHTH EDITION

Thoroughly updated, the eighth edition provides an in-depth analysis of current issues, which readers have come to expect from *Principles of Risk Management and Insurance*. Timely changes include discussion of the following:

1. **Impact of September 11th attacks on the insurance industry.** Acts of terrorism are a relatively new fundamental risk that merits increased attention. The impact of such attacks on commercial property and liability insurers, workers compensation, and life and health insurance is discussed in relevant chapters, including Chapter 26.
2. **New tax law changes affecting qualified retirement plans.** Chapter 20 discusses the Economic Growth and Tax Relief Reconciliation Act of 2001. The new law substantially increases the amount of annual contributions to an individual retirement account (IRA), Section 401(k) plan, and qualified defined contribution and defined benefit retirement plans.
3. **Voluntary personal retirement accounts under Social Security.** The President's Commission to Strengthen Social Security has recommended that workers should be allowed to invest part of their Social Security taxes to establish personal retirement accounts. Chapter 24 discusses this issue.
4. **Updated discussion of advanced topics in risk management.** Chapter 4 presents an updated discussion of advanced topics in risk management, from enterprise risk management and the current "hard" underwriting cycle in property and liability insurance to new technology in risk management, such as risk mapping.
5. **Credit scoring.** An increasing number of auto and homeowners insurers are now using credit scores for purposes of underwriting and rating.
- Credit scoring—an emerging regulatory issue—is discussed in Chapters 11 and 28.
6. **New ISO commercial property insurance program.** Chapter 13 discusses the new edition of the Insurance Services Office commercial property insurance program. Numerous commercial coverages have been revised to better serve the insurance needs of business firms.
7. **New ISO commercial general liability policy.** Chapter 14 discusses the new ISO commercial general liability (CGL) policy that became effective in most states in October 2001.
8. **New ISO commercial crime insurance program.** Chapter 15 discusses the new ISO commercial crime insurance program for most private firms and nonprofit organizations. The chapter also discusses financial institution bonds for commercial banks and other financial institutions.
9. **Rising health-care costs.** Chapter 21 discusses the latest research data concerning the escalation in health-care costs, a factor that is contributing to the increase in the number of uninsured in the United States.
10. **Updated discussion of managed care plans.** Chapter 22 focuses on managed care plans and also provides an "Insight" box on relatively new defined contribution health plans that some employers are now introducing to control rising health-care costs.
11. **Federal estate tax changes.** Chapter 19 discusses the new Economic Growth and Tax Relief Reconciliation Act of 2001, which substantially increases the amount of property exempt from the federal estate tax.
12. **Long-term actuarial deficit for Social Security and Medicare.** Chapter 24 discusses the long-term actuarial deficit for both Social Security and Medicare and the various solutions for eliminating the deficit.

KEY FEATURES OF THE EIGHTH EDITION

1. **Continued emphasis on the Internet.** Many instructors use the Internet to supplement their courses. The eighth edition provides updated Web sites that students can easily access. The eighth edition also has an Internet site (*www.*

aw.com/rejda). After studying each chapter, students can take a self-administered test online and get instant feedback on how well they have mastered the material.

2. **Streamlining of “Insight” boxes.** Instructors and students have enthusiastically endorsed the “Insight” boxes in previous editions. “Insights” are powerful learning tools that provide real-world applications of key principles or concepts discussed in the chapter. Most “Insights” in the previous edition have been replaced by compelling new ones. Readers will find these and other attention-getting headlines throughout the text:

- September 11th Terrorist Attack: Analysis of the Impact on the Insurance Industry
- Terrorist Attacks—New Federal Reinsurance Pool Proposed
- Are Acts of Terrorism Excluded by the War Clause?
- Compensability of Terrorism Injuries Under State Workers Compensation Laws
- Term Life Insurance Looks Even Better After September 11
- Defined Contribution Health Plan That Puts Employee in Charge Catches on
- Medical Errors Rank with Highway Accidents and Breast Cancer as a Major Killer in the United States
- Ten Common 401(k) Mistakes
- How To Save Social Security: Check Out the Social Security Game
- Toxic Mold Claims: A Critical Problem in Homeowners Insurance
- Don’t Ignore Gap Insurance If You Lease a Car
- Warning: Internet Shopping May Not Produce the Best Price
- Why Are Healthcare Costs Going Up?

3. **Technical accuracy.** As in past editions, numerous risk management and insurance experts have reviewed the text for technical accuracy, especially in areas where changes have occurred rapidly. The eighth edition offers the most technically accurate and up-to-date information available.

4. **Clarity in writing.** Risk management and insurance topics can intimidate students if set forth

in a disjointed or abstract manner. Since readability is critical, the book persists in presenting principles and concepts clearly and directly, and strives to be the most user-friendly of texts.

SUPPLEMENTS

The eighth edition contains a number of supplementary materials to help busy instructors save time and teach more effectively. The following items are available to qualified domestic adopters, but in some cases may not be available to international adopters.

Companion Web Site As noted earlier, the eighth edition provides an Internet site (available at *www.aw.com/rejda*) that offers self-administered quizzes and web-based exercises corresponding to each chapter. The Companion Web Site system provides an online syllabus builder that allows instructors to create a calendar of assignments for each class and to track student activity with an electronic grade book.

Instructor’s Manual with Transparency Masters Designed to reduce start-up costs and class preparation time, this comprehensive manual contains teaching notes; lecture outlines; answers to all end-of-chapter review, application, and case questions; and transparency masters that illustrate key points.

Revised Test Bank Prepared by Michael J. McNamara of Washington State University, this revised test bank enables instructors to construct objective exams quickly and easily. The test bank contains new mini-case objective questions to test students’ critical thinking and analytical skills.

Study Guide Also prepared by Michael J. McNamara, this study tool is an improvement over traditional study guides. The guide contains exercises that enable students to apply basic concepts to their own personal risk management program. Each chapter contains objective questions similar to test bank questions, worksheets (where appropriate) for solving end-of-chapter cases, and answers to all questions at the end of each chapter for quick reference and self-testing.

Instructor's Resource CD-ROM Fully compatible with Windows and Macintosh computers, this CD-ROM provides a number of resources. First, PowerPoint lecture slides of all figures and tables from the text enhance classroom presentations. Instructors with Microsoft PowerPoint 97, 98, or higher can customize the slides by adding their personal lecture notes. Second, for added convenience, the CD-ROM contains Microsoft Word files for the entire contents of the instructor's manual. Finally, the CD-ROM includes computerized test bank files. The easy-to-use software is a valuable test preparation tool that allows professors to view, edit, and add questions.

ACKNOWLEDGMENTS

A market-leading textbook is never written alone. I owe an enormous intellectual debt to many people for their kind assistance. Numerous educators, risk management and insurance experts, and industry personnel have taken time out of their busy schedules to review part or all of the eighth edition, to provide supplementary materials, to make valuable comments, or to provide other assistance. They include the following:

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Special thanks are due Professor Michael J. McNamara of Washington State University. Professor McNamara revised Chapter 4 on advanced topics in risk management, and the study guide as well. He also revised the test bank and reviewed each chapter for clarity and technical accuracy. As a result, the eighth edition is a substantially improved product. Finally, I would like to thank all those at Addison-Wesley who have contributed to the success of this book through its many editions.

It is my hope that the eighth edition of this text has succeeded in fulfilling its fundamental aim, which it shares with all the previous editions: to be an intellectually stimulating and visually attractive textbook from which students can learn and professors can teach.

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University of Nebraska—Lincoln*

CONTENTS

Preface xv

PART ONE	BASIC CONCEPTS IN RISK MANAGEMENT AND INSURANCE	1
CHAPTER 1	RISK IN OUR SOCIETY	2
	Meaning of Risk	3
	Chance of Loss	4
	Peril and Hazard	5
	Basic Categories of Risk	6
	Types of Pure Risk	7
	Burden of Risk on Society	11
	Methods of Handling Risk	11
	Summary 14 ■ Key Concepts and Terms 15 ■ Review Questions 15	
	Application Questions 15 ■ Selected References 15 ■ Notes 16	
	Case Application	16
	INSIGHT 1.1: MAKING ENDS MEET CAN BE TOUGH FOR WIDOWS	8
	INSIGHT 1.2: RUNAWAY CAR HITS TODDLER, KILLS HER FATHER	10
CHAPTER 2	INSURANCE AND RISK	17
	Definition of Insurance	18
	Basic Characteristics of Insurance	18
	Requirements of an Insurable Risk	20
	Two Applications: The Risks of Fire and Unemployment	22
	Adverse Selection and Insurance	22
	Insurance and Gambling Compared	23
	Insurance and Hedging Compared	24
	Types of Insurance	24
	Benefits of Insurance to Society	27
	Costs of Insurance to Society	28
	Summary 30 ■ Key Concepts and Terms 31 ■ Review Questions 31	
	Application Questions 31 ■ Selected References 32 ■ Notes 32	
	Case Application	31
	INSIGHT 2.1: INSURANCE FRAUD COMES IN ALL SHAPES AND SIZES	29
	Appendix Basic Statistics and the Law of Large Numbers	33
CHAPTER 3	INTRODUCTION TO RISK MANAGEMENT	37
	Meaning of Risk Management	38
	Objectives of Risk Management	38
	Steps in the Risk Management Process	39

	Identifying Potential Losses	39
	Evaluating Potential Losses	40
	Selecting the Appropriate Techniques for Treating Loss Exposures	41
	Implementing and Administering the Risk Management Program	48
	Personal Risk Management	48
	Summary 50 ■ Key Concepts and Terms 51 ■ Review Questions 51	
	Application Questions 52 ■ Selected References 53 ■ Notes 53	
	Case Application 1	52
	Case Application 2	53
	INSIGHT 3.1: WHY DO EMPLOYERS SELF-INSURE THEIR GROUP HEALTH PLANS?	44
CHAPTER 4	ADVANCED TOPICS IN RISK MANAGEMENT	54
	The Changing Scope of Risk Management	55
	Insurance Market Dynamics	59
	Loss Forecasting	62
	Financial Analysis in Risk Management Decision Making	64
	Use of Technology in Risk Management Programs	66
	Summary 70 ■ Key Concepts and Terms 70 ■ Review Questions 70	
	Application Questions 71 ■ Selected References 72 ■ Notes 72	
	Case Application 1	71
	Case Application 2	72
	INSIGHT 4.1: THE FINAL FRONTIER OF RISK	58
	INSIGHT 4.2: ENHANCED RISK MAPPING	68
	Appendix Loss Forecasting Using the Normal Distribution	74
PART TWO	LEGAL PRINCIPLES IN RISK AND INSURANCE	77
CHAPTER 5	FUNDAMENTAL LEGAL PRINCIPLES	78
	Principle of Indemnity	79
	Principle of Insurable Interest	81
	Principle of Subrogation	83
	Principle of Utmost Good Faith	85
	Requirements of an Insurance Contract	86
	Distinct Legal Characteristics of Insurance Contracts	88
	Law and the Insurance Agent	89
	Summary 91 ■ Key Concepts and Terms 92 ■ Review Questions 92	
	Application Questions 93 ■ Selected References 94 ■ Notes 94	
	Case Application	93
	INSIGHT 5.1: NO INSURABLE INTEREST AT THE TIME OF DEATH: IS A CORPORATION ENTITLED TO THE LIFE INSURANCE PROCEEDS?	83
	INSIGHT 5.2: MISREPRESENTATION IN APPLICATION FOR AUTO COVERAGE	85

CHAPTER 6	ANALYSIS OF INSURANCE CONTRACTS	96
	Basic Parts of an Insurance Contract	97
	Definition of the "Insured"	100
	Endorsements and Riders	100
	Deductibles	101
	Coinsurance	102
	Coinsurance in Health Insurance	104
	Other-Insurance Provisions	104
	Summary 106 ■ Key Concepts and Terms 107 ■ Review Questions 107	
	Application Questions 107 ■ Selected References 109 ■ Notes 109	
	Case Application	108
	INSIGHT 6.1: ARE ACTS OF TERRORISM EXCLUDED BY THE WAR CLAUSE?	99
PART THREE	PERSONAL PROPERTY AND LIABILITY RISKS	111
CHAPTER 7	THE LIABILITY RISK	112
	Basis of Legal Liability	113
	Law of Negligence	113
	Imputed Negligence	115
	Res Ipsa Loquitur	116
	Specific Applications of the Law of Negligence	116
	Special Tort Liability Problems	119
	Reforming the Civil Justice System	123
	Summary 125 ■ Key Concepts and Terms 126 ■ Review Questions 126	
	Application Questions 126 ■ Selected References 127 ■ Notes 128	
	Case Application	127
	INSIGHT 7.1: MEDICAL ERRORS RANK WITH HIGHWAY ACCIDENTS AND BREAST CANCER AS A MAJOR KILLER IN THE UNITED STATES	120
	INSIGHT 7.2: MAN SUES FATHER, BUT IT'S NOTHING PERSONAL	122
CHAPTER 8	HOMEOWNERS INSURANCE, SECTION I	129
	Homeowners 2000 Program	130
	Analysis of Homeowners 3 Policy (Special Form)	134
	Section I Coverages	134
	Section I Perils Insured Against	140
	Section I Exclusions	144
	Section I Conditions	146
	Section I and II Conditions	150
	Summary 151 ■ Key Concepts and Terms 151 ■ Review Questions 152	
	Application Questions 152 ■ Selected References 153 ■ Notes 154	
	Case Application	153
	INSIGHT 8.1: RENTERS INSURANCE IS A MUST IF YOU RENT AN APARTMENT OR HOUSE	131
	INSIGHT 8.2: TOXIC MOLD CLAIMS: A CRITICAL PROBLEM IN HOMEOWNERS INSURANCE	142

	INSIGHT 8.3: ACTUAL CASH VALUE COVERAGE ON PERSONAL PROPERTY CAN COST YOU A BUNDLE	147
CHAPTER 9	HOMEOWNERS INSURANCE, SECTION II	155
	Personal Liability Insurance	156
	Section II Exclusions	157
	Section II Additional Coverages	161
	Endorsements to a Homeowners Policy	162
	Shopping for a Homeowners Policy	165
	Summary 171 ■ Key Concepts and Terms 171 ■ Review Questions 172	
	Application Questions 172 ■ Selected References 173 ■ Notes 173	
	Case Application	172
	INSIGHT 9.1: NEW POLICIES FOR HOME INSURANCE	166
	INSIGHT 9.2: SURVEY REVEALS CUSTOMER SATISFACTION WITH HOME INSURERS	170
	Appendix How Can I Save Money on a Homeowners Policy?	174
CHAPTER 10	AUTOMOBILE INSURANCE	177
	Overview of Personal Auto Policy	178
	Part A: Liability Coverage	179
	Part B: Medical Payments Coverage	184
	Part C: Uninsured Motorists Coverage	185
	Part D: Coverage for Damage to Your Auto	188
	Part E: Duties After an Accident or Loss	194
	Part F: General Provisions	194
	Insuring Motorcycles and Other Vehicles	195
	Summary 196 ■ Key Concepts and Terms 196 ■ Review Questions 197	
	Application Questions 197 ■ Selected References 199 ■ Notes 199	
	Case Application	198
	INSIGHT 10.1: DON'T LET ROAD RAGE GET YOU KILLED	182
	INSIGHT 10.2: USING A CELL PHONE WHILE DRIVING—HOW RISKY?	191
	INSIGHT 10.3: DON'T IGNORE GAP INSURANCE IF YOU LEASE A CAR	193
	Appendix Summary of 1998 Personal Auto Policy Coverages	200
CHAPTER 11	AUTOMOBILE INSURANCE AND SOCIETY	203
	Approaches for Compensating Automobile Accident Victims	204
	Auto Insurance for High-Risk Drivers	212
	Cost of Auto Insurance	214
	Shopping for Auto Insurance	219
	Summary 223 ■ Key Concepts and Terms 224 ■ Review Questions 224	
	Application Questions 224 ■ Selected References 225 ■ Notes 226	
	Case Application	225
	INSIGHT 11.1: WHAT YOUR AUTO INSURER KNOWS ABOUT YOU	218
	INSIGHT 11.2: STUDY SHOWS AMERICANS COULD SAVE HUNDREDS ON AUTO INSURANCE	222

CHAPTER 12	OTHER PROPERTY AND LIABILITY INSURANCE COVERAGES	227
	ISO Dwelling Program	228
	Mobilehome Insurance	229
	Inland Marine Floaters	230
	Insurance on Pleasure Boats	231
	Government Property Insurance Programs	232
	Title Insurance	237
	Personal Umbrella Policy	238
	Summary 241 ■ Key Concepts and Terms 241 ■ Review Questions 242	
	Application Questions 242 ■ Selected References 243 ■ Notes 243	
	Case Application	244
	INSIGHT 12.1: MYTHS AND FACTS ABOUT THE NATIONAL FLOOD INSURANCE PROGRAM	234
	INSIGHT 12.2: THE PERILS AN UMBRELLA POLICY CAN PROTECT AGAINST	240
 PART FOUR	 COMMERCIAL PROPERTY AND LIABILITY RISKS	 245
CHAPTER 13	COMMERCIAL PROPERTY INSURANCE	246
	Overview of Commercial Package Policy	247
	Building and Personal Property Coverage Form	248
	Causes-of-Loss Forms	252
	Reporting Forms	254
	Business Income Insurance	254
	Other Commercial Coverages	257
	Transportation Insurance	259
	Businessowners Policy (BOP)	264
	Summary 265 ■ Key Concepts and Terms 267 ■ Review Questions 267	
	Application Questions 267 ■ Selected References 268 ■ Notes 268	
	Case Application	268
	INSIGHT 13.1: EXAMPLES OF COVERAGE UNDER THE BUILDING AND PERSONAL PROPERTY COVERAGE FORM	250
	INSIGHT 13.2: ADVANTAGES OF THE SPECIAL CAUSES-OF-LOSS FORM	253
 CHAPTER 14	 COMMERCIAL LIABILITY INSURANCE	 270
	General Liability Loss Exposures	271
	Commercial General Liability Policy	273
	Employment Practices Liability Insurance	278
	Workers Compensation and Employers Liability Insurance	280
	Commercial Auto Insurance	281
	Aviation Insurance	284
	Bailee's Customer Insurance	285
	Commercial Umbrella Policy	286
	Liability Insurance, Businessowners Policy	287
	Professional Liability Insurance	288
	Summary 290 ■ Key Concepts and Terms 291 ■ Review Questions 291	
	Application Questions 292 ■ Selected References 293 ■ Notes 293	

	Case Application	293
	INSIGHT 14.1: COMPENSABILITY OF TERRORISM INJURIES UNDER STATE WORKERS COMPENSATION LAWS	282
	INSIGHT 14.2: FLORIDA DOCTOR OPERATES ON WRONG SIDE OF HEAD	289
CHAPTER 15	CRIME INSURANCE AND SURETY BONDS	295
	ISO Commercial Crime Insurance Program	296
	Commercial Crime Coverage Form	297
	Financial Institution Bonds	301
	Surety Bonds	302
	Summary 305 ■ Key Concepts and Terms 306 ■ Review Questions 306 Application Questions 306 ■ Selected References 307 ■ Notes 308	
	Case Application	307
	INSIGHT 15.1: EMPLOYEE THEFT A COMMON PROBLEM	298
	INSIGHT 15.2: CONSTRUCTION IS RISKY BUSINESS	303
PART FIVE	LIFE AND HEALTH RISKS	309
CHAPTER 16	FUNDAMENTALS OF LIFE INSURANCE	310
	Premature Death	311
	Financial Impact of Premature Death on Different Types of Families	312
	Amount of Life Insurance to Own	314
	Methods for Providing Life Insurance Protection	322
	Summary 325 ■ Key Concepts and Terms 326 ■ Review Questions 326 Application Questions 326 ■ Selected References 328 ■ Notes 328	
	Case Application 1	327
	Case Application 2	327
	INSIGHT 16.1: GET LIFE INSURANCE—BEFORE IT'S TOO LATE	312
	INSIGHT 16.2: LIFE EXPECTANCY IN U.S. HITS NEW HIGH	313
	INSIGHT 16.3: LIFE INSURANCE: THREE FAMILIES' NEEDS	320
	INSIGHT 16.4: LIFE INSURANCE STUDY REVEALS CRISIS OF UNDERINSURANCE	323
CHAPTER 17	TYPES OF LIFE INSURANCE	329
	Types of Life Insurance	330
	Variations of Whole Life Insurance	336
	Other Types of Life Insurance	344
	Summary 347 ■ Key Concepts and Terms 348 ■ Review Questions 348 Application Questions 348 ■ Selected References 349 ■ Notes 350	
	Case Application	349
	INSIGHT 17.1: TERM LIFE INSURANCE LOOKS EVEN BETTER AFTER SEPTEMBER 11	334
	INSIGHT 17.2 : WHEN CASH-VALUE LIFE INSURANCE MAKES SENSE	336

CHAPTER 18	LIFE INSURANCE CONTRACTUAL PROVISIONS	351
	Life Insurance Contractual Provisions	352
	Dividend Options	358
	Nonforfeiture Options	360
	Settlement Options	361
	Additional Life Insurance Benefits	365
	Summary 369 ■ Key Concepts and Terms 370 ■ Review Questions 371	
	Application Questions 372 ■ Selected References 373 ■ Notes 373	
	Case Application	372
	INSIGHT 18.1: IS THIS DEATH A SUICIDE?	353
	INSIGHT 18.2: SELECTING THE BEST DIVIDEND OPTION	359
	INSIGHT 18.3: PLAYING THE DEATH POOL	370
CHAPTER 19	BUYING LIFE INSURANCE	374
	Determining the Cost of Life Insurance	375
	Rate of Return on Saving Component	379
	Taxation of Life Insurance	381
	Shopping for Life Insurance	383
	Summary 387 ■ Key Concepts and Terms 388 ■ Review Questions 388	
	Application Questions 388 ■ Selected References 389 ■ Notes 389	
	Case Application	388
	INSIGHT 19.1: FACTORS TO CONSIDER IN REPLACING A LIFE INSURANCE POLICY	379
	INSIGHT 19.2: WARNING: INTERNET SHOPPING MAY NOT PRODUCE THE BEST PRICES—NEW CFA STUDY RATES 36 PERCENT OF TERM INSURANCE WEBSITES AS “NOT RECOMMENDED”	385
	Appendix Is Your Life Insurance Reasonably Priced? (How to Evaluate an Existing Life Insurance Policy)	390
CHAPTER 20	ANNUITIES AND INDIVIDUAL RETIREMENT ACCOUNTS	395
	Individual Annuities	396
	Types of Annuities	397
	Taxation of Individual Annuities	402
	Individual Retirement Accounts	404
	Summary 409 ■ Key Concepts and Terms 410 ■ Review Questions 410	
	Application Questions 410 ■ Selected References 411 ■ Notes 412	
	Case Application	411
	INSIGHT 20.1: WHEN DO VARIABLE ANNUITIES MAKE SENSE?	403
CHAPTER 21	INDIVIDUAL HEALTH AND DISABILITY-INCOME INSURANCE	413
	Health Care Problems in the United States	414
	Types of Individual Health Insurance Coverages	417
	Hospital-Surgical Insurance	419
	Major Medical Insurance	420
	Long-Term Care Insurance	422

	Disability–Income Insurance	423
	Individual Medical Expense Contractual Provisions	428
	Shopping for Health Insurance	430
	Summary	433 ■ Key Concepts and Terms 435 ■ Review Questions 435
	Application Questions	436 ■ Selected References 437 ■ Notes 437
	Case Application	436
	INSIGHT 21.1: WHY ARE HEALTHCARE COSTS GOING UP?	416
	INSIGHT 21.2: THE SOBERING STATISTICS ON DISABILITY–INCOME INSURANCE	432
	INSIGHT 21.3: THE LAST RESORT: STATE HIGH–RISK POOLS FOR THE UNINSURABLE	433
CHAPTER 22	EMPLOYEE BENEFITS: GROUP LIFE AND HEALTH INSURANCE	438
	Group Insurance	439
	Group Life Insurance Plans	441
	Group Medical Expense Insurance	444
	Types of Group Medical Expense Plans	445
	Managed Care Plans	447
	Group Medical Expense Contractual Provisions	452
	Group Dental Insurance	455
	Group Disability–Income Insurance	456
	Cafeteria Plans	457
	Summary	458 ■ Key Concepts and Terms 459 ■ Review Questions 460
	Application Questions	460 ■ Selected References 460 ■ Notes 461
	Case Application	461
	INSIGHT 22.1: CREDIT INSURANCE OVERCHARGES HIT \$2.5 BILLION ANNUALLY	443
	INSIGHT 22.2: DEFINED–CONTRIBUTION HEALTH PLAN THAT PUTS EMPLOYEE IN CHARGE OF SPENDING CATCHES ON	451
	INSIGHT 22.3: WHAT HAPPENS TO MY HEALTH INSURANCE IF I LOSE MY JOB?	455
CHAPTER 23	EMPLOYEE BENEFITS: RETIREMENT PLANS	462
	Fundamentals of Private Retirement Plans	463
	Types of Qualified Retirement Plans	470
	Defined–Contribution Plans	470
	Defined–Benefit Plans	470
	Section 401(k) Plans	472
	Profit–Sharing Plans	473
	Retirement Plans for the Self–Employed	474
	Simplified Employee Pension (SEP)	476
	SIMPLE Retirement Plans	476
	Funding Agency and Funding Instruments	477
	Summary	478 ■ Key Concepts and Terms 479 ■ Review Questions 480
	Application Questions	480 ■ Selected References 481 ■ Notes 481
	Case Application	480

**INSIGHT 23.1: TEN COMMON CAUSES OF ERRORS IN PENSION CALCULATION:
CONSUMER TIPS FOR SAFEGUARDING YOUR PENSION 467**

INSIGHT 23.2: TEN COMMON 401(K) MISTAKES 474

CHAPTER 24 SOCIAL INSURANCE 482

Social Insurance 483

Old-Age, Survivors, and Disability Insurance (OASDI) 485

Types of Benefits 486

Problems and Issues 495

Unemployment Insurance 498

Workers Compensation 501

Summary 506 ■ Key Concepts and Terms 507 ■ Review Questions 507

Application Questions 507 ■ Selected References 507 ■ Notes 508

Case Application 508

INSIGHT 24.1: GET THE PICTURE ON YOUR SOCIAL SECURITY BENEFITS 492

**INSIGHT 24.2: HOW TO SAVE SOCIAL SECURITY:
CHECK OUT THE SOCIAL SECURITY GAME 496**

**INSIGHT 24.3: SOCIAL INSURANCE PROGRAMS
AND THE SEPTEMBER 11 ATTACKS 504**

PART SIX THE INSURANCE INDUSTRY 511

CHAPTER 25 TYPES OF INSURERS AND MARKETING SYSTEMS 512

Types of Private Insurers 513

Agents and Brokers 519

Types of Marketing Systems 519

Mass Merchandising 522

Summary 523 ■ Key Concepts and Terms 524 ■ Review Questions 524

Application Questions 524 ■ Selected References 525 ■ Notes 525

Case Application 525

INSIGHT 25.1: HOLDING COMPANY SCHEMES: THE FEELING ISN'T MUTUAL 517

INSIGHT 25.2: PAYROLL PLAN LETS WORKERS SAVE MONEY AND CHECKS 523

CHAPTER 26 INSURANCE COMPANY OPERATIONS 526

Insurance Company Operations 527

Rate Making 527

Underwriting 528

Production 532

Claim Settlement 533

Reinsurance 535

Investments 541

Other Insurance Company Functions 542

Summary 542 ■ Key Concepts and Terms 543 ■ Review Questions 543

Application Questions 544 ■ Selected References 544 ■ Notes 544

Case Application 545

	INSIGHT 26.1: FREQUENTLY ASKED QUESTIONS ABOUT THE MEDICAL INFORMATION BUREAU	531
	INSIGHT 26.2: THE SEPTEMBER 11 TERRORIST ATTACK: ANALYSIS OF THE IMPACT ON THE INSURANCE INDUSTRY	538
	INSIGHT 26.3: TERRORIST ATTACKS—NEW FEDERAL REINSURANCE POOL PROPOSED	540
CHAPTER 27	INSURANCE PRICING	546
	Objectives of Rate Making	547
	Basic Definitions in Rate Making	548
	Rate Making in Property and Liability Insurance	548
	Rate Making in Life Insurance	551
	Reserves in Property and Liability Insurance	556
	Life Insurance Policy Reserves	560
	Summary 562 ■ Key Concepts and Terms 563 ■ Review Questions 563	
	Application Questions 563 ■ Selected References 564 ■ Notes 564	
	Case Application	564
	INSIGHT 27.1: PROFITABILITY OF THE INSURANCE INDUSTRY AND OTHER INDUSTRIES	559
CHAPTER 28	GOVERNMENT REGULATION OF INSURANCE	566
	Reasons for Insurance Regulation	567
	Historical Development of Insurance Regulation	568
	Methods for Regulating Insurers	569
	What Areas Are Regulated?	570
	State Versus Federal Regulation	577
	Current Issues in Insurance Regulation	579
	Summary 588 ■ Key Concepts and Terms 589 ■ Review Questions 589	
	Application Questions 590 ■ Selected References 590 ■ Notes 591	
	Case Application	590
	INSIGHT 28.1: AUTO INSURANCE COMPLAINTS IN NEW YORK STATE	574
	INSIGHT 28.2: INSURANCE DEPARTMENT REPORT CARD	586
	Appendix A Homeowners 3 (Special Form)	593
	Appendix B Personal Auto Policy	617
	Appendix C Whole Life Policy	631
	Appendix D Universal Life Policy	647
	Glossary	657
	Index	671